HACKING AT THE FEDERAL RESERVE

(The following remarkably clear article which appeared recently in the Saturday Evening Post, written by Will Payne, should be read by everybody. Congress is inclined to meddle with this wonderful system and the people ought to understand the law in order to protest.)

(Continued from last week.)

To agriculture especially deflation was a monstrously oppressive process. Within a year prices of all farm products taken together fell more than one-half—to a level, in a great many cases, below the cost of production; and much of this drop occurred just when the main crops of 1920 were coming to market.

Farmers, like other manufacturers, operate a good deal on credit, buying cattle and hogs and feed with borrowed money and borrowing in the spring to carry through until harvest. The drop in prices caught farmers when the crops of 1920 were ready for market, after all costs of production had been met, with high-priced labor and materials, and when their liabilities were largest. Farmers by the ten thousand could not pay their debts.

Now the big drop in general prices coincided to a degree with a rise in the rediscount rates of the Federal Reserve Banks. Without looking further quite a lot of people charged the fall in prices to the rise in reserve rediscount rates because the two things happened more or less at the same time, exactly as free-silverites twenty-five years ago used to charge low prices to the demonetization of silver, but as prices afterwards rose greatly while silver still remained demonetized it was evident that silver had not been keeping prices down. So discount rates had practically nothing to do with the fall in agricultural prices, as a little candid examination of the subject will show.

Agriculture, taking the net product, not the gross, produces about one-fifth of the wealth of the nation. In 1919 this net product amounted to around $15,000,000,000. It is produced by 6,500,000 persons. In the main—and this is particularly true of the big items, such as cotton, wheat, cattle, hogs—these producers are quite unorganized. Each of them just produces, puts his goods on the market and takes what the market gives him in the way of price. Usually the selling is done as soon as the goods are ready for market.

But we produce much more cotton, wheat and meat than we consume at home, the surplus being sold abroad. As to cotton, for forty years before the World war two-thirds of the crop was exported—we grew one pound for ourselves and two pounds for Europe. Of course the export price largely governed the price of the whole crop. Many of you will remember that when the war, in 1914, shut off exports cotton became almost unsalable at any price and President Wilson joined the buy-a-bale-of cotton movement. War reduced exports somewhat, but stimulated domestic consumption, cotton being used for many war purposes. Almost one-half of the 1918 crop was exported in the raw state, however, and the export demand continued to be a great factor in fixing the domestic price.

Of the wheat crop in late years we have consumed three-quarters and exported one-quarter. But by a well-known economic law it is the last bushel that largely fixes the price. You put ten bushels of apples on a market in which there are ten buyers each wanting a bushel. The whole ten bushels will move off smoothly at a normal price. But when you put ten bushels on a market in which there are buyers for only nine bushels, in the haggling of the market the price of the whole ten bushels will fall until somebody turns up to take the final bushel. So although the domestic demand for wheat remains unchanged the price will fall until the surplus one-quarter, normally exported, is disposed of. In 1918 we easily worked off a bumper yield at high prices because hungry Europe still had buying power left and took nearly a third of the crop off our hands.

Before the World war our exports of agricultural products ran about $1,000,000,000 a year. In the fiscal year 1917 this rose to $2,000,000,000, and in 1919 to $3,500,000,000. Our total exports in the calendar year 1919 amounted to $8,000,000,000 in round numbers—a performance in the foreign-trade line such as no other nation ever came within gunshot of before and which probably no nation will ever again approach in this generation. It was altogether abnormal and there was a bogus element in it. Europe and the United States were in a hectic post-war inflation and a very important part of these huge exports was sold on time to debtors who were exhausting their credit. The inflation continued, however, well into 1920. By June of that year wholesale prices had risen to 275 as compared with 201 in the February following the armistice—which about marks the beginning of the postwar boom. In a year bank loans had risen $5,000,000,000. Federal Reserve rediscounts as compared with February following the armistice had increased $1,000,000,000. Then the gas began to go out of the balloon. Export demand from exhausted Europe began decidedly to break down.

It happened that in the spring of 1920 crop prospects were not very good, which tended to stimulate the price of farm products. But the prospects steadily improved. In fact, the agricultural outturn was the largest in five years, grain breaking all records except that for 1915, while the cotton fields yielded 13,700 000 bales against an average of little more than 11,000,000 bales in each of the five preceding years—just at a time when buying power was drying up.

Moreover, commodity prices had been steadily advancing for a year and a half, going far above the wartime level. A great many people were getting restless thereat and starting a buyer's strike. Japan had gone through a financial panic that shook her out of her shoes. Danger signals were flying; deflation was in the air. The Department of Agricultrue's index number, compounded of the price of thirty-one farm products, stood at 246 in June, as the big crops were approaching harvest. It fell to 242 in July, 225 in August, 207 in September, 191 in October—the movement beginning slowly and gathering momentum as the general situation was more clearly revealed the size of the crops was more definitely known and the new grain and cotton began moving to market in the face of a shrinking export demand.

Now under such circumstances nothing except some fantastic scheme of government valorization could have held farm prices even temporarily. The boom was collapsing; we had far more farm goods than there were buyers for; the price was bound to fall. By December the index number for agricultural prices had fallen to 143, by March to 122, by June, 1921, to 106, or decidedly less than half what it had been the year before. No such precipitous fall in prices had ever happened before, yet the same thing in lesser degree followed the war of 1812 and the Civil War, prices reaching the peak after the war and falling sharply. A collapsing boom, big crops and the breakdown of European buying caused the fall in 1920-21.

Deflation hit agriculture hardest because it is most exposed. When the demand for steel falls off the mills at once cut down production. But the farms, broadly speaking, go on producing just the same. Steel mills in the summer of 1921 were producing about one-quarter of their capacity; but the farms, notwithstanding last year's ruinous drop in prices produced substantially the same amount of grain as in 1918 and 1919 when grain brought top prices. The cotton crop was very much smaller than last year's, but that was due quite as much to bad weather and the boll weevil as to reduced acreage. Of course a series of calamitous years the country over would reduce yields, but for any comparatively short view the farmer is tied to his job of producing whether it ruins him or not.

When The Bubble Burst.

Other labor strikes when wages are unsatisfactory. Railroad labor declared a nationwide tie-up of transportation because its wages were reduced to seven-eighths of what they had been in 1920. That labor said: "We will not produce at the reduced pay." As mentioned above, Doctor King figures that for producing the crop of 1920 farmers received as wages for their labor less than one-quarter what they had received before. But that agricultural labor went right ahead and produced a new crop. In the nature of the case, farm products and farmers' labor are more exposed to a headlong drop in prices than manufactured products or other labor is.

A joint commission of the Senate and House of Representatives held hearings on this subject for weeks. Much other evidence is available. There is no reason to suppose that any action the Federal Reserve Banks could have taken would have had any noticeable effect upon the fall in farm prices. A bubble burst and farmers were most exposed to the force of the explosion. Probably organized co-operative marketing would have helped to ease the blow, but there was no such organization. No doubt, also, farmers and cattle growers needed better facilities for long-time credit—nine months and year credit. But such credit is entirely outside the field of the Federal Reserve Banks.

Now, as to the part played by the reserve system. The fall in farm prices began in June, 1920, when bank credit was already extended to the limit—and beyond a reasonable limit. Loans and discounts of the thirty-odd thousand banks which do the country's primary banking business, exclusive of the Federal Reserve institutions had risen beyond $31,000,000,000 of this expansion had occurred in two years and over $5,000,000,000 of it had occurred in the last 12 months, or long after the end of the war. The Federal Reserve Banks had already extended credit to these individual banks to the amount, in round numbers, of $3,000,000,000. Some of the reserve banks were practically at the end of their lending power—for that power is by no means unlimited, and it ought to be understood clearly that nothing but fiat and depreciated money can give unlimited lending power. Danger signals were flying. It was a time for deflation, not for further inflation. Months before this, Federal Reserve Banks had begun warging member banks that credit was too extended. Six months before, they had taken somewhat more effectual means to check further inflation by raising their rediscount rates.

As prices fell the first thought of many farmers and stock raisers was, quite naturally, to carry along on borrowed money in the hope that prices would rise again. They found the country's credit structure already loaded to the danger point. It should be remembered, however, that the farming and stock-raising country had its full share of the credit already extended, for expansion and inflation had gone on as briskly in the country as elsewhere. A report made by the Comptroller of the Currency as of November 15, 1920, classifies about 70 per cent of the total loans and discounts of the national banks according to the occupation of the borrower. Farmers' and stock-raisers' paper amounted to a fifth of the whole. As a rule country banks that were soundly managed would not have materially increased their loans no matter what the Federal Reserve rediscount rates had been. Candid country bankers have so testified. They were loaned to the limit. The band was stretched as far as it would go without breaking.

A great volume of credit was extended to farmers and stock raisers. Federal Reserve Banks serving the chief agricultural regions exhausted their own lending power and borrowed from Federal Reserve Banks of the East in order to keep on rediscounting. Agricultural products were carried to a great extent; and farm stuff was held back from market to an extraordinary degree, as the market statistics show. Some 5,000 000 bales of the 1920 cotton crop—or nearly half a normal crop—were carried over into the 1921 crop year, counting visible and invisible stocks. Owing to bad weather, boll weevil and some reduction of acreage, the 1921 cotton outturn was far the smallest in many years. That caused the price to advance. So a banker who loaned a cotton grower money to enable him to carry his cotton over to 1921 did him a service. But as to wheat and most other farm products the longer it was carried the worse off the holder was. Carrying over a crop is a speculation in which one is very likely to lose unless a crop calamity next year helps him out.

Money Rates Kept Low.

Though a great volume of credit was extended to farmers and stock raisers, the supply was not equal to the demand. There was a demand for credit which the credit resources of the country could not meet. By that time the credit resources of the country were popularly regarded as being in the keeping of the Federal Reserve System, and there was a great deal of criticism of that system. Very often denial of credit meant hardship for the applicant, and quite often the hard-pressed local banker, feeling bound to deny the application, passed the buck to the Federal Reserve System, for he would naturally rather have the disappointed applicant blame that far-away system than blame him. The Federal Reserve Banks began raising rediscount rates in December, 1919. Presently prices began to fall, and a good deal of thoughtless criticism, putting the nearest two and two together, drew the false conclusion that rising rediscount rates were responsible for falling prices.

In fact, the legitimate criticism of the Federal Reserve Banks is not that they began raising rediscount rates at the very end of 1919 but that they failed to raise rediscount rates much earlier; and there seems to be no doubt that they would have raised rediscount rates earlier but for the opposition of the Treasury Department—which is worth a moment's consideration as illustrating that not even the most powerful government in the world can, finally, prevent water from running down-hill.

When the United States entered the World War it was clear that the Government would borrow immense sums. The Treasury Department wished to float the loans at the lowest possible interest rate. Out of patriotism the public and the banks readily subscribed to all the Liberty Bond issues although the bonds bore a rate of interest lower than nonsentimental conditions warranted. Through moral suasion the Government practically commandeered the money at less than the market rate. But in order to float the loans the rediscount rates of the Federal Reserve Banks were also held below the market. Throughout the war almost any bank anywhere would lend money on a Liberty Bond at a rate of interest no higher than that borne by the bond. Almost anybody could subscribe for a Liberty Bond, make a small initial payment and have the local bank carry the bond indefinitely. The transaction cost him nothing, for the bank charged only the same rate of interest that the bond drew. It cost the bank nothing either, for it could immediately hand over the subscriber's note, with the bond attached, to the nearest Federal Reserve Bank which would discount the note at 4 per cent. It amounted to this: "Write your name to a bond subscription and make a small initial payment. Your bank will then carry the subscription for you free of cost and the Federal Reserve Bank will carry it for your bank free of cost."

The Inflation Of 1919.

As a war measure, no doubt, that was justified. The Government wished a big popular subscription to the bonds not only because it needed the money but also for the moral effect of showing a united people. The armistice left the Government with some billions of unfounded debt. The Victory Liberty Loan of $3,500,000,000 was soon offered for subscription, and after that the Treasury was carrying out shorter-time financing on an immense scale. A low Federal Reserve rediscount rate had been of incalculable value in floating the war loans, and the Treasury wanted the rediscount rates kept low while it was doing its post-war financing. In fact, the rediscount rate was kept well below the mark throughout 1919.

The obvious result was to make borrowing from a Federal Reserve Bank very profitable to the member banks. A member bank could readily lend money at 6 or 7 per cent and then rediscount the note at a Federal Reserve Bank at 4 or 5 per cent. Bankers being only human, I have no doubt that this helped on the reckless inflation of 1919. And it was quite contrary to the theory of reserve or central banking. The theory is that banks other than the reserve bank will have sufficient funds to take care of the ordinary average demands of business. In an emergency, or under unusual conditions they can turn to the reserve bank and keep themselves in cash by rediscounting paper. But they should not make a profit out of resorting to the reserve bank; for that bank is supposed to be the custodian not of the main army but only of the reserve, and the reserve should not be drawn into action unless there is real unavoidable need. Thus reserve banks such as the Bank of England and the Bank of France normally hold their rediscount rates slightly above the market. In short, banks should not be paid a handsome premium for drawing on the reserve; but in 1919, generally speaking, we were paying them a handsome premium, because the Treasury Department wished to hold the rediscount rate low in order to facilitate its own financing.

When the Federal Reserve Banks raised rediscount rates—finally to 7 per-cent in some districts, including New York, and to 6 per cent in others—there was a good deal of complaint from member banks because that cut down, or cut off, their profits. The object of the reserve system, however, was not to make banking more profitable but to make it safe.

There was complaint also, of a progressive discount rate which some of the reserve banks adopted. Each member bank was allowed a normal or basic line of credit proportioned to its resources. It could rediscount at its Federal Reserve Bank up to that normal line at the regular rediscount rate; but if it went 25 per cent above the normal line it must pay 1 per cent premium, and so on. The object, of course, was to check expansion of credit in those spots where it had gone farthest. It should be understood that all through the pinch many member banks were rediscounting less than their normal line, many others only up to their normal line, while a few went much above the normal line. As the president of a Federal Reserve Bank put it, "We have high-pressure banks and low-pressure banks and medium-pressure banks." The object of the progressive rate was to put brakes on the high-pressure banks. Of course the object of raising the rediscount rates at all was to check a dangerous inflation and not to make a profit for the reserve banks.

Those institutions are not operated for profit, as the term is usually understood. Their capital stock is held by the member banks and dividends are limited to 6 per cent. All profits above 6 per cent are turned into the National Treasury. Raising the rediscount rates did, of course, increase the profits of the Federal Reserve Banks, which meant increasing the revenues of the Government.

It is charged that Federal Reserve Banks discriminated against agricultural paper, but I have seen no evidence to support the charge. It is true that many farmers and stock raisers needed long-time credit—nine months or a year—which the Federal Reserve Banks are wisely forbidden by law to extend. But as to paper which they are permitted to rediscount, there was no discrimination against agricultural paper.

Naturally the Federal Reserve Banks were rediscounting much more paper at New York than at Atlanta or Kansas City because there was much more paper there to be rediscounted. A great number of the local banks in the agricultural regions are state banks which do not belong to the Federal Reserve System and cannot therefore rediscount paper directly at a Federal Reserve Bank. Such banks manage their reserves and rediscounts on the plan that obtained before the reserve system was inaugurated—that is, they keep a certain proportion of their reserves on deposit with a national or state bank in Atlanta, Omaha, Minneapolis, Chicago or New York, and when they require credit they turn to their city bank for it.

Pressure From The Treasury.

As a rule such nonmember country banks keep two reserve accounts, one in the nearest commercial center and one in New York or Chicago. In a pinch such banks borrow from their city banks, but in almost every case the city bank is a member of the Federal Reserve System and it, in turn, borrows from the Federal Reserve Bank in its city. Thus a pull from the country falls with cumulative force upon the Federal Reserve Banks in the big reserve cities. In the Kansas City region, at least, until the progressive discount rate was put into effect country banks, even though they were members of the Federal Reserve System, very generally rediscounted at their city banks instead of at the Federal Reserve Bank, and let the city bank hand the load on to the Federal Reserve. That was the way they had been used to borrowing and they kept it up.

The experience of the last half of 1920 has often been described as agriculture's worst calamity in the United States. Inevitably the strain fell upon the country banks. I think there is no doubt that there would have been many country bank failures except for the help extended by the Federal Reserve System. In view of the situation, country bank failures were few. Apparently the Federal Reserve Banks permitted no really solvent member bank to fail.

Perhaps it is human nature to look to one's injuries rather than to one's benefits. Many applicants were denied further credit, there was much hardship and much criticism. Inevitably the blessed old tribal tomtoms of "Wall Street" and "Big Business" were dragged out and whacked lustily. As a matter of fact liquidation at New York was as drastic as elsewhere. The Federal Reserve Banks are not permitted to rediscount stock-market paper—paper secured by stocks and bonds, other than government bonds. In fact, the reserve system served the country well through deflation. The one conspicuous blot on its record, I believe, is that it failed to raise rediscount rates until December, 1919. There seems no doubt that failure is traceable to political pressure from the Treasury Department, which wanted an easy money market while its big financial operations were carried out. The Treasury would have done better if it had paid somewhat more for the money it borrowed.

The agricultural calamity furnishes nearly all the ammunition for attacks on the Federal Reserve System. In general the obvious purpose of the attacks is to get more politics into the system and make it more amenable to political pressure. In that respect it is simply a greenback and free-silver movement in modern guise. Almost all our business is done on credit. Our everyday money is credit money. Whatever you buy you hand over to the seller a promise to pay—either an engraved piece of paper which recites that the Treasury or a Federal Reserve Bank will pay the bearer so many dollars on demand, or a lithographed and signed piece of paper called a check, which amounts to a promise that the bank on which it is drawn will pay so many dollars and cents on demand. Whatever you sell you receive such a promise to pay. It all goes on promise.

A Road To Avoid.

These promises to pay are good when they are honestly based on liquid assets—that is, on goods moving into consumption—wheat in a warehouse that is on its way to a bread basket, materials in process of manufacture, goods on merchants' shelves that are passing into the hands of buyers and users. If the stuff is flowing into consumption the paper will liquidate itself and the promises honestly based on it are good. But when the promises begin very materially to exceed the liquid assets they begin to turn bad. When German bank notes were based on liquid assets every mark was worth par. They are now mostly based on unliquid government bonds, or mere fiat, and a mark is worth about half a cent.

Any government's fiat can make money, but no government's fiat can make good money, not even that of the richest government in the world. If the Federal Reserve Banks should be required to extend credit, which means issuing promises to pay on demand when liquid means of redeeming those promises are not in hand, that would be nothing but fiat—in principle the same thing as Germany's issuance of fiat marks. Of course you will be told "A vigorous financial system can digest some fiat. Nobody dreams of having the United States go to any such lengths as Europe has gone. We will go only a few rods along that road, at most only half a mile, and then stop." Which is like the old proposition, "Certainly we shall not get drunk; we will take only three or four moderate drinks and then go straight home."

Since the road plainly leads to the gutter and is so marked by big legible signs of world experience why go any length upon it. Why even start on it? As to any rotten road, the time to stop is before you start. It looks to me as though an attempt would be made to chevy us along the rotten road—very plausibly and persuasively—by requiring the Federal Reserve Banks to extend credit when sound principles would forbid the extension of credit, and especially by getting more politics and politicians into the system. This propaganda is directed especially to farmers and stock raisers, they having been the first victims of deflation. But adulterating the country's credit reservoir can bring nothing but harm in the end to any class or interest—excepting some speculators who are always at hand to pick a profit out of a calamity.

Quackery works a twofold injury—doping the patient and at the same time keeping him from seeking true remedies for his ailment. Telling farmers and stock raisers that the remedy for such a misfortune as befell them last year is to be found in adulterating the Federal Reserve System dopes with a false hope and tends to distract their attention from organized marketing and sound schemes of long-time credit outside of commercial banking and the reserve system. We don't want another government operation of railroads or another shipping board in our credit system. Vote no on any proposition to get more politics and more political appointees into the Federal Reserve System. Any proposal to amend the Federal Reserve Law that is opposed by the Federal Reserve Board should be regarded with acute suspicion.

PORTSMOUTH, O.

The many friends of R. L. Johnson and Mrs. Lutie Workman will be surprised to hear of their marriage which took place in Ironton, Ohio, Saturday, January 14. The wedding ceremony was performed by Rev. Malone. The happy couple returned to Portsmouth and are now busy receiving the congratulations of their many friends.

Mr. Johnson is a popular N. and W. boilermaker.

Mrs. Johnson has many friends at Louisa. She spent the summer with her father, George B. Rickman at Zelda. They have gone to housekeeping at 2946 Gallia, East Portsmouth.

KENTUCKIAN.